**BEFORE THE INSURANCE COMMISSIONER**
**OF THE STATE OF WASHINGTON**

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| In the Matter of the Application regarding the Conversion and Acquisition of Control of Premera Blue Cross and its Affiliates | Docket No. G02-45<br><br>FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL ORDER |

## I. PROCEDURAL HISTORY

This matter comes before Mike Kreidler, the Insurance Commissioner for the State of Washington (the "Commissioner") on the application of PREMERA and Premera Blue Cross, and their affiliated companies, (collectively, "Premera"), filed with the Office of the Insurance Commissioner ("OIC"), seeking the approval of the Commissioner for the reorganization of Premera that will result in a change of control of the holding company system and the conversion of the nonprofit affiliates to for-profit companies. The issuance of these Findings of Fact, Conclusions of Law, and Final Order (the "Final Order") is the product of an extensive review of Premera's application for reorganization, which is comprised of a Form A and Form D filings (collectively referred to as the "Application" or the "Form A"). The review process culminated in a public adjudicative hearing conducted pursuant to the

Administrative Procedure Act, Chapter 34.05 RCW, which was held from May 3, 2004, to May 19, 2004, in Tumwater, Washington.[1]

I presided over the hearing and, as the final decision maker, am issuing this Final Order. At the hearing evidence was offered by Premera, the OIC Staff Review Team, and the Interveners. All parties were represented by counsel.[2] Forty-one witnesses presented live testimony and 290 exhibits were admitted into the record. Included among the exhibits are 27 expert reports that provide analyses of the proposed transaction.

Prior to the formal adjudicative hearing I held two rounds of public hearings in various locations around the state. The first round was held after the filing of the Form A but prior to the issuance of any expert reports in September and October of 2002 with hearing sites in Seattle, Spokane, Richland, and Vancouver. The second round was held after the issuance of the experts' initial reports in December 2003 with hearing sites in Spokane, Yakima, SeaTac, and Bellingham. Testimony was taken under oath from the public during the second round of hearings, and both sets of hearings were recorded and transcribed. Written public comment was also accepted through May 21, 2004, with 5,815 communications in the form of postcards, e-mails, letters, and phone calls being received.

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[1] George Finkle, who was appointed Special Master in this matter and is a retired King County Superior Court judge, conducted the hearing.

[2] The OIC Staff Review Team (the "Staff" or "Review Team") is led by James T. Odiorne, Deputy Insurance Commissioner for Company Supervision. The Staff's lead counsel from the Washington Attorney General's Office is Assistant Attorney General Melanie deLeon and Special Assistant Attorney General John Hamje. Premera is represented by the law firm of Preston, Gates, & Ellis LLP, with Thomas Kelly and Robert Mitchell as lead counsel. The Intervener groups are represented as follows. The Premera Watch Coalition is represented by Eleanor Hamburger of Columbia Legal Services. The Washington State Hospital Association and Association of Washington Public Health Districts are represented by Michael Madden of Bennet, Bigelow & Leedom, P.S. The Washington State Medical Association is represented by Jeffrey Coopersmith of the Coopersmith Law Group. Finally, the Alaska interveners are represented by Amy McCullough of the Alaska Legal Services Corporation and Ardith Lynch on behalf of the University of Alaska.

Premera formally notified me and the Attorney General of its intention to reorganize and convert from a nonprofit company to a for-profit company in letters dated May 30, 2002. S-71; S-96.[3] Premera acknowledged in the letters that the Insurance Commissioner has jurisdiction over the transaction under the Insurance Code, in particular the Holding Company Acts, Chapters 48.31B and 48.31C RCW. Premera further acknowledged the Attorney General's authority to review certain aspects of the transaction regarding the dissolution of the nonprofit corporations and transfer of assets under the Nonprofit Corporation Act, Chapters 24.03 and 24.06 RCW. The respective roles of the Insurance Commissioner and the Attorney General are outlined in a memorandum dated October 15, 2002, to the Attorney General from her staff, which she shared with me and was made public prior to the commencement of these proceedings. I-2. In addition, in a letter dated November 19, 2002, the Attorney General informed me that the Attorney General's Office ("AGO") would not initiate a separate and independent antitrust review of the transaction but that the AGO would act in a consultative role with the OIC Staff. C-14.

On September 17, 2002, Premera filed its initial Form A concurrently with the Office of the Insurance Commissioner and the Office of the Attorney General seeking our respective approvals of the proposed reorganization, conversion to for-profit, and dissolution and distribution of all the assets of the Premera nonprofit companies. C-1. On October 24, 2002, I issued a Case Management Order establishing the general procedures for the adjudicative hearing process and a separation of functions for personnel within the OIC so that there would

[3] References to hearing exhibits carry a prefix designating the party followed by the number of the exhibit, such as "P-1" for a Premera exhibit, "S-1" for a Staff exhibit, "I-1" for an Intervener exhibit, and "C-1" for an exhibit adopted into the record by the Commissioner. Not all originally proposed exhibits were offered, and some exhibit numbers were reserved but not used. As result, the numbers of the exhibits admitted into the record do not in all cases follow one after the other. References to the transcript of the hearing will be cited as "TR" followed by the page number.

no *ex parte* communications with me regarding the merits of the Application.[4] In addition, I set a deadline of November 26, 2002, by which any person intending to seek intervener status pursuant to RCW 48.31B.015(4) and 48.31C.030(4) had to file a motion to intervene.[5]

Pursuant to the authority granted under the Holding Company Act, RCW 48.31B.015(4)(c) and 48.31C.030(5)(b), the OIC Staff retained consultants to review Premera's Application. Premera and the Interveners also engaged experts to evaluate the Form A. The Staff and their consultants initiated their review in October 2002. Over the course of their review, they examined over 40,000 pages of documents and conducted numerous interviews of Premera's management and key employees.

As early as February 2003, the OIC informed Premera that there were significant substantive problems with the proposed reorganization and gave Premera the opportunity to address those concerns and revise the transaction prior to the consultants issuing their reports. Included among the concerns was the absence of the detailed stock ownership plan that Premera intended to implement if the conversion were approved. Premera declined to revise its Form A and represented that it would wait to address any problems until after the issuance of the experts' reports.

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[4] The Form A, filings of the parties, expert reports, transcripts, and orders are posted on the website of the Office of the Insurance Commissioner at www.insurance.wa.gov.

[5] I issued an order on February 10, 2003, permitting intervention of numerous organizations and forming them into four intervener groups, as follows: (1) **Premera Watch Coalition,** which consists of Washington Citizen Action, Welfare Rights Organizing Coalition, American Lung Association of Washington, Northwest Federation of Community Organizations, Northwest Health Law Advocates, Service Employees International Union Washington State Council, The Children's Alliance, Washington Academy of Family Physicians, Washington Association of Churches, Washington Protection and Advocacy System, and Washington NOW. The Coalition was also joined by the Washington Association of Community and Migrant Health Centers, which represents 36 health care centers located in 24 Washington counties; (2) **The Hospital Associations,** which consists of the Washington State Hospital Association and the Washington Public Hospital Districts; (3) **The Washington State Medical Association,** which consists of 8,800 members who provide healthcare services to Washington citizens; (4) **The Alaska Interveners**, which includes the University of Alaska, United Way of Anchorage, John Garner (a disabled individual), and Anchorage Neighborhood Health Center. The University of Washington School of Medicine and its components were also granted intervener status but later withdrew their participation.

I requested and received status reports from the parties in February and March, 2003. With the agreement of all the parties, Judge Finkle was appointed Special Master on April 7, 2003. Prior to discovery beginning, Premera requested that a protective order be issued to protect trade secret and proprietary information shared with the parties during these proceedings. A protective order was negotiated among the parties, mediated by the Special Master, and adopted and issued by me on June 13, 2003.

The Special Master recommended a Case Schedule to be triggered upon the production of certain documents by Premera, which I adopted on August 19, 2003. The schedule was triggered on August 26, 2003. However, the Case Schedule was shortened as a result of a stipulation entered on September 12, 2003, in Thurston County Superior Court resolving an administrative appeal by Premera of my Case Management Order. The stipulation recited that I would issue my decision by March 15, 2003. Consequently, the Case Schedule was adjusted accordingly.

Premera was required to file any amendments to the Form A by October 15, 2003. The OIC consultants' final reports were due on October 27, 2003, and Premera's and the Interveners' reports were due on November 10, 2003. The hearing was scheduled for January 15 through 28, 2004. However, the hearing was extended twice at the request of Premera and with the consent of the OIC Staff. The extensions were requested because Premera wanted the opportunity to amend its Form A to address problems raised by the OIC's consultants in their expert reports. Premera filed an amended Form A on February 5, 2004. The parties' consultants subsequently filed supplemental reports on their review of the transaction as amended. The amended Form A, including the stock ownership plan that was ultimately submitted by Premera, is the subject of these proceedings.

## II. APPLICABLE LAW

Chapter 48.31B RCW, the Insurer Holding Company Act, and Chapter 48.31C, the Health Carrier Holding Company Act, govern the proposed transaction. (hereinafter collectively referred as "the Holding Company Act").[6] In addition, because the reorganization involves the dissolution of nonprofit corporations and the distribution of their assets, Chapters 24.03 and 24.06 RCW of the Nonprofit Corporations and Associations Act also apply. The Administrative Procedure Act, Chapter 34.05 RCW, has governed the adjudicatory proceedings throughout this case. The most relevant statutory provisions are set forth in Attachment A and are briefly summarized below.

The Holding Company Act regulates, among other things, the acquisition of control of a domestic carrier. RCW 48.31B.015 and 48.31C.030. The acquiring party must submit the transaction to the OIC for review. The commissioner must approve the transaction unless there is a basis for disapproval as set fort the in the statute (also referred to as Form A standards). The bases for disapproval are summarized as follows: (1) After the transaction, the carrier would not be able to satisfy the requirements for the issuance of a license; (2) The effect of the acquisition may substantially lessen competition in this state or tend to create a monopoly (but the commissioner may not disapprove the transaction on this ground if it will yield substantial economies of scale or in resource use not otherwise obtainable, or will substantially increase or prevent significant deterioration in the availability of insurance, and the public benefits that

[6] Chapter 48.31B governs the acquisition of insurers, other than health care service contractors ("HCSCs") and health maintenance organizations ("HMOs"). Chapter 48.31C. governs the acquisition of control of HCSCs and HMOs. Because the reorganization of Premera's holding company system involves both insurers and HCSCs, both chapters apply. However, the substantive and procedural requirements of Chapters 48.31B and 48.31C are essentially the same. Consequently, for ease of reference and because the focus of the review is on the conversion to for-profit of Premera Blue Cross, a HCSC, this Final Order will primarily refer to Chapter 48.31C RCW.

arise from the economies or availability of insurance exceed the public benefits that would arise from more competition); (3) The financial condition of the acquiring party is such as might jeopardize the financial stability of the domestic carrier, or prejudice the interests of subscribers; (4) Plans for a material change after the acquisition are unfair and unreasonable to its subscribers and not in the public interest; (5) The competence, experience, and integrity of those persons who would control the carrier are such that it would not be in the interests of the entity's subscribers and the public to permit the transaction; or (6) The acquisition is likely to be hazardous or prejudicial to the insurance-buying public. RCW 48.31C.030(5)(a) and 48.31B.015(4)(a).

The Holding Company Act also governs agreements and transactions between companies within an insurance holding company system. The standards for transactions within a holding company system (also referred to as Form D standards) include whether the terms are fair and reasonable. RCW 48.31B.030 and 48.31C.050. Because companies within a holding company system are under common control, review of intercompany transactions by the OIC is an important check to prevent conflicts of interest or financial self-dealing.

Because the reorganization proposed by Premera requires the dissolution of Washington nonprofit corporations and the distribution of their assets, Washington's nonprofit corporation law applies, in particular RCW 24.03.225 and .230, and RCW 24.06.265. The law, as applicable in this case, requires that a nonprofit corporation's assets be distributed in accordance with its articles of incorporation, in accordance with a plan of distribution approved by the Attorney General, or in accordance with a plan of distribution adopted by the corporation.

## III. FINDINGS OF FACT

Though the evidence related to some factual issues and the opinions of some experts are conflicting, I have carefully weighed all of the evidence in reaching these Findings of Fact. Even though I specifically refer to certain testimony and documentary evidence to explain my findings, my findings are based on a review of all the evidence and are supported by the preponderance of the evidence. No particular finding is essential to my decision to disapprove Premera's Form A.

### A. Summary of the Form A

1. The Form A Statement relates to the acquisition of control of Premera Blue Cross, a Washington nonprofit health care service contractor ("Premera" or "PBC"), Lifewise Assurance Company , a Washington for-profit insurance company ("LWA"), LifeWise Health Plan of Washington, a Washington nonprofit health care service contractor ("LifeWise Washington"), LifeWise Health Plan of Arizona, Inc., a Washington for-profit insurance company ("LW-AZ"), Premera Blue Cross Blue Shield of Alaska Corp., an Alaska for-profit insurance company ("PBC-AK"), and LifeWise HealthPlan of Oregon, Inc., an Oregon for-profit insurance company ("LifeWise Oregon") (collectively referred to as the "Acquired Companies"), all of which are affiliates of the parent company PREMERA, a Washington nonprofit corporation, by a to be formed new entity, New PREMERA Corp., a Washington for-profit corporation. The Alaska Division of Insurance issued a certificate of authority to PBC-AK to operate as a licensed health insurer in that state subject to the consummation of the transactions proposed in Premera's Form A.

2. Premera engages in the health insurance business in Washington and Alaska under the Blue Cross mark. LifeWise Washington operates as a nonprofit in the health

insurance business in those counties in Washington where Premera is precluded from marketing under the Blue mark because the local Blue Shield company, Regence, has the license to use the mark in those counties.

3. The reorganization of the holding company system is proposed to be accomplished through a series of transactions that will occur simultaneously pursuant to which the parent company (PREMERA), Premera Blue Cross, and LifeWise Washington will convert from Washington nonprofit corporations organized under Titles 24.06 and 24.03 RCW, respectively, to Washington for-profit corporations organized under Titles 23B RCW.

4. The Washington Foundation Shareholder ("Washington Foundation"), a Washington nonprofit corporation, and the Alaska Health Foundation ("Alaska Foundation"), an Alaska nonprofit corporation, are to be created and will become members of PREMERA. The end result of the proposed transaction is that the Washington and Alaska Foundations will own 100% of the new parent company (New PREMERA). The steps of the transaction to reach this result are as follows.

5. PBC will transfer certain of its assets and liabilities directly related to its operations in Alaska to its newly formed, wholly owned subsidiary, PBC-AK, in exchange for 100% of the stock of PBC-AK. PBC will then transfer of all of its assets and liabilities, including the stock of PBC-AK, to its other newly formed, wholly owned subsidiary, New PBC, a Washington for-profit corporation, in exchange for 100% of the stock of New PBC. After the foregoing transfer, PBC-AK will become a direct wholly owned subsidiary of New PBC.

6. PBC will then perform a statutory liquidation and distribute the New PBC stock to its parent PREMERA. New PBC will transfer 100% of the stock of PBC-AK to

PREMERA at which point New PBC and PBC-AK are direct wholly owned subsidiaries of PREMERA. PREMERA will then transfer all of its assets and liabilities to its newly formed wholly owned for-profit subsidiary, New PREMERA, in exchange for 100% of the stock of New PREMERA. PREMERA will then perform a statutory liquidation and distribute the New PREMERA stock to its sole members, the Washington and Alaska Foundations.

7. After the completion of the proposed transaction, the Washington and Alaska Foundations collectively will own 100% of the capital stock of New PREMERA, and New PREMERA will directly or indirectly control the Acquired Companies. However, the Foundations will disclaim control of the Acquired Companies within the meaning of RCW 48.31B.005(2) and 48.31C.010(3).

8. In connection with the proposed transaction, PREMERA, PBC, and LifeWise Washington will seek a solicitation permit from the Office of the Insurance Commissioner in accordance with RCW 48.06.040.

9. Because the proposed transaction involves regulated insurance entities in Washington, Alaska, and Oregon, PREMERA sought approval from the insurance commissioners in all three states as to one or more parts of the transaction. In addition, because the reorganization involves the dissolution of Washington nonprofit corporations, PREMERA is seeking the approval of the Washington Attorney General regarding the distribution of the assets of PREMERA, PBC, and LifeWise Washington.

10. There are numerous transaction documents filed as exhibits with the Form A. However, there are certain documents that were the subject of significant discussion at the hearing that bear special note. They are the Transfer, Grant, and Loan Agreement (“TGLA”), the Voting Trust and Divestiture Agreement (“VTDA”), the Excess Share Escrow Agent

Agreement, the Registration Rights Agreement, and the BCBSA License Agreement. A brief description of each follows.

11. The Transfer, Grant, and Loan Agreement provides for the transfer of New PREMERA Stock to the Washington and Alaska Foundations upon the dissolution of PREMERA. The Foundations will be required to make distributions of proceeds derived from the sale of the stock to fund health initiatives in their respective states by making grants or gifts to one or more nonprofit organizations.

12. The Voting Trust and Divestiture Agreement sets forth the terms for the exercise of the voting rights of the New PREMERA shares to be owned by the Washington and Alaska Foundations. Under the terms of the agreement, while the Foundations will retain their economic interests in the New PREMERA stock, they are required to place 90% to 95% of the voting power of all New PREMERA stock in voting trusts administered by trustees. The trustees will generally be required to vote the shares as directed by an independent majority of the board of directors of New PREMERA. The VTDA also requires the Foundations to divest their New PREMERA stock so as to meet maximum ownership amounts at various anniversary dates following the date of the initial public offering of New PREMERA stock. The Foundations, in aggregate, will be permitted to own no more than 80% of the stock of New PREMERA following the first anniversary of the initial public offering, no more than 50% after the third anniversary, no more than 20% after the fifth anniversary, and no more than 5% after the tenth anniversary. If the Foundations fail to follow the divestiture schedule, New PREMERA has the right to compel a sale of any shares in excess of the maximum ownership limits. The excess shares will be deposited in an escrow

account so that they are available for sale by New PREMERA in accordance with the Excess Share Escrow Agent Agreement.

13. The Registration Rights Agreement sets forth the terms for the registration pursuant to applicable securities laws of the New PREMERA stock held by the Foundations in order to effect the divestiture of the stock. Among other restrictions on the Foundations' ability to freely sell their stock, New PREMERA decides the number of shares to be offered by New PREMERA, the Washington Foundation Shareholder, and the Alaska Health Foundation during the initial public offering.

14. The Blue Cross Blue Shield Association ("BCBSA") License Agreement will be entered into between New PREMERA and the BCBSA granting certain licenses to the Blue Cross trademark. The License Agreement allows New PREMERA and its Blue Cross subsidiaries to operate as for-profit companies on the condition that no institutional investor shall become the beneficial owner of securities representing 10% or more of the voting power of the company, no non-institutional investor shall become the beneficial owner of securities representing 5% or more of the voting power of the company, and no person shall become beneficial owner of 20% or more of the company's outstanding stock. However, these limitations do not apply to a Blue plan that is a beneficial owner of another Blue plan.[7]

**B. Review of Premera's Reasons for Conversion**

15. Premera's Application seeks permission to convert its nonprofit affiliates, Premera Blue Cross ("Premera" or "PBC") and LifeWise of Washington ("Lifewise") to for-profit companies.

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[7] The term "Blue plan" refers to health plans that are licensed by the Blue Cross & Blue Shield Association.

16. Premera does not bear the burden of proving that conversion is necessary to its business survival. Consideration of Premera's stated reasons for conversion, however, is useful in reviewing the transaction as a whole.

17. Premera's primary stated reasons for conversion are: (1) to increase Risk-Based Capital ("RBC")[8]; (2) to improve products and services; (3) to support subscriber growth; (4) to preserve autonomy; (5) to operate on a level playing field with other health carriers; and (6) to improve retention of management .

18. Premera proposes raising \$100 to \$150 million at the Initial Public Offering ("IPO") and would have the option to raise additional capital in subsequent stock offerings.

19. Premera's RBC level was 433% as of December 31, 2003, increased from 406% as of December 31, 2002. If Premera had not incurred the \$31 million + cost of its present effort to convert, its RBC level would have probably been greater than 450% at the time of the public conversion hearing in May 2004.

20. The Blue Cross Blue Shield Association ("BCBSA" or "Association") monitors a plan if its RBC level falls below 375%.

21. Pursuant to RCW 48.05.430 *et seq*. a company must take measures if its RBC level is 2.0 or 200%. The Office of the Insurance Commissioner will initiate regulatory review if a company's RBC level is 1.5 or 150%. Delinquency proceedings will commence if the company hits the mandatory control level of .70 or 70%.

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[8] RBC is "a method of measuring the minimum amount of capital appropriate for an insurer to support its overall business operations in consideration of its size and risk profile. It provides an elastic means of setting the capital requirement in which the degree of risk taken by the insurer is the primary determinant." The major categories of risk are asset risk, underwriting risk, credit risk, and business risk. *NAIC Health Risk-Based Capital Report* 10/01/03.

22. RBC levels at the end of 2002 for Blue plans comparable to Premera ranged from 245% to 846%, averaging 623%.

23. As was asserted by many witnesses on behalf of Premera and the OIC Staff, Premera is presently financially sound and can remain sound with or without conversion.

24. Premera's consultant, Donna Novak, testified that at its current RBC level Premera is capitally constrained. According to Ms. Novak a capitally constrained company must consider how proposed actions would affect its near term capital levels, which can result in a short-range business focus. Ms. Novak recommends that Premera's minimum RBC goal should be 500%. However, this is her generic recommendation for all Blue plans. Ms. Novak did not and was not asked by Premera to calculate the optimal RBC level for Premera based on its operational requirements.

25. Ms. Novak speculated, as she had not done the analysis, that increasing Premera's RBC to 500% could take more than five years. However, a review of the comparable plans offered by Ms. Novak shows that other nonprofit Blue plans (BCBS Minnesota, BCBS of North Carolina, and Care First of MD) increased their RBC levels in one year by 75 percentage points, 68 percentage points, and 75 percentage points, respectively.

26. Alternative methods for increasing RBC are debt financing and surplus notes. Premera could also generate RBC level increases through income and investments, which is how it was able to increase its RBC by 27 percentage points from 2002 to 2003, even as it spent heavily on conversion efforts.

27. I find persuasive OIC Staff consultant Jonathan Koplovitz's testimony that Premera is not capitally constrained. Instead, Premera has embarked on long term capital-intensive projects, including expansion into Arizona and the $125 million development of the

Dimensions product. In addition, Premera has not identified specific projects that are waiting for the capital Premera intends to raise. Nor has Premera calculated the costs and benefits of potential projects, or fully considered to what extent equity capital, as opposed to other sources of capital, is needed.

28. Mr. Koplovitz observed that, in his experience, Premera's approach to this transaction has been the opposite of other companies planning a conversion. Rather than having specifically-identified capital requirements dictate the need for a conversion and the amount of capital that should be raised, Premera has first decided how much it plans to raise at the IPO and will decide at a later date how that capital will be specifically used.

29. Premera asserts that it will be able to improve products and services for customers if it gains access to the capital markets as a for-profit company. Premera offers its success with the Dimensions product as a generic example of the type of project that it could undertake in the future given adequate capital. Premera witnesses also suggested possible improvements in its communications with providers and customers, as well as increased medical staffing and other programs within the Premera organization itself.

30. Premera, however, has not developed any specific product or service projects that it would implement if it had access to capital through the equity markets. It has not projected the funds it would dedicate to such projects. Nor has it calculated the administrative or medical expense savings, if any, it could make or would target to make by improving products and services.

31. All businesses, whether nonprofit or for-profit, must prioritize their initiatives. Premera represents that, regardless of whether it is permitted to convert, it will continue to

invest in products, services, infrastructure, and operational efficiencies, but that enhanced access to capital through conversion would help it to meet its goals more quickly.

32. Premera has targeted annual increases of 4% in its insured business and 5% in its administrative service business, regardless of whether it converts.

33. Premera believes that it can more easily achieve such targeted increases if it has access to equity capital. Premera further believes that improved services and products will attract more subscribers, and that an increased RBC level will support the risk associated with additional subscribers.

34. Large group contracts, such as Premera's contract with Microsoft, are often administrative service contracts ("ASC"). In ASCs the "insurance risk" remains with the employer, who pays an administrative fee to Premera to administer the employer's health plan. In ASC business, there is not a direct correlation between increasing the number of people served under the contract and the need to increase RBC, because Premera is not assuming risk on those contracts.

35. Premera is pursuing a strategy to obtain large "national accounts," similar to Microsoft, which would increase the percentage of its overall business represented by ASCs. Based on Premera's targeted growth in ASC business, ASCs would constitute a significant portion of Premera's business by 2007.

36. Premera's ASC business is currently not profitable. While the direct costs of the ASC business are being covered by the administrative contract fees, the fees are not covering allocated fixed costs, i.e. the ASC's share of overhead.

37. PriceWaterhouseCoopers October 27, 2003, *Economic Impact Analysis Report* provides a brief history of the consolidation and conversion of Blue Cross and Blue Shield plans.

38. The report states at page 101:

> The number of independent Blue Cross and Blue Shield plans has dropped from over 125 in the early 1980's to 63 in 1996 and down to 41 today. Initially, consolidation was primarily among geographically adjacent plans that retained not-for-profit status. Since 1995, over half of the states have seen consolidation activity among Blue Cross and Blue Shield plans and a visible subset of these have been acquisitions and for-profit conversions of Blues plans that had been organized as not-for-profit or mutual insurance companies under state insurance laws.

39. The growth of for-profit Blue plans began in the mid-1990's. The current marketplace has two multi-state, for-profit Blues plans, Wellpoint Health Networks and Anthem.

40. Early conversion efforts received more limited scrutiny from state regulators, as there was not a full understanding of the potential impact of conversions on the availability and affordability of health insurance and the need to protect the public's interests in the value of the converting Blue plan.

41. The formal conversion of the California Blue plan, WellPoint, in 1996 illustrates such problems. Wellpoint accomplished a *de facto* conversion in 1993 by creating a for-profit subsidiary, transferring all of the assets of the non-profit to this for-profit subsidiary, and issuing stock in the newly created for-profit. No public review considered whether the proposed *de facto* conversion was in the interest of the subscribers or the public. State officials were successful only after the fact in having proceeds from the sale of stock transferred to health care foundations for the public benefit.

42. Wellpoint has acquired Blue plans in Georgia, Missouri, and Wisconsin since converting to for-profit. It attempted to acquire CareFirst, a Blue plan that operated in Maryland, Washington DC, and northern Virginia, but the proposal was denied by the Maryland Insurance Commissioner.

43. Anthem was originally an Indiana Blue company. Since becoming a for-profit, it has acquired Blue plans in Kentucky, Ohio, Connecticut, New Hampshire, Colorado, Nevada, Maine, and Virginia. Its proposal to acquire the New Jersey plan was canceled, and the Kansas acquisition was denied by the Kansas Insurance Commissioner.

44. Wellpoint and Anthem presently have a merger application pending before other states' insurance regulators. A merger of Wellpoint and Anthem would leave only two for-profit Blue plans – Anthem/Wellpoint and WellCHOICE of New York.

45. WellCHOICE is the only independent for-profit Blue plan. Other Blue plans that initially converted to independent for-profits, i.e. were not acquired by a for-profit plan at the outset, have all since been acquired.

46. I agree with the views of Premera's CEO Gubby Barlow, Board Member Sally Jewell, and other witnesses, that Premera can best serve its subscribers and the Washington insurance-buying public by maintaining responsiveness to the needs of consumers and health care providers that derives from local management and autonomy. Negative effects of the loss of local control and ownership include those outlined in the *Premera Conversion Study, Report 2* at pages 29 to 35, prepared by the Health Policy Analysis Program of the University of Washington.

47. Premera's states that it has no plans of being acquired. Based upon the experience of other converted plans, however, there is a high likelihood that if Premera

converts to a for-profit company, it will be acquired by a national insurer such as Anthem or WellPoint. As several witnesses testified and history indicates, once a nonprofit plan converts, the road to a subsequent acquisition can be appealing to management and is relatively easier.

48. A for-profit Premera board of directors would have a fiduciary responsibility to its shareholders to maximize shareholder value regardless of the CEO's and the board's present intention to remain independent. For example, if Premera were faced with a purchase offer at more than its then-existing share price (as was the case when WellPoint offered to purchase RightCHOICE, the converted Missouri Blue, at double its share price) the financial rewards of such a buy-out to shareholders would have to be given primacy by the Premera board and management over the benefits of local ownership and control to Premera subscribers and to the Washington insurance-buying public.

49. The risk is great that, contrary to Premera's goal of retaining independence, conversion would result in the loss of that independence.

50. Premera has also asserted that it should be permitted to convert to a for-profit in order to be able to operate on "a level playing field." The playing field in Washington is presently dominated by nonprofit health carriers. The two largest carriers, Premera and Regence, are nonprofit Blue plans. As of 2002, Premera and Regence had roughly equal shares totaling approximately 56% of insured business. The third major Washington carrier is the nonprofit Group Health, which has about 19% of the insured market. In total approximately 75% of the insured Washington market is currently being served by nonprofit health carriers, with the remaining 25% divided among national carriers and small local or

specialized plans, none with more than a 6% market share. Premera operates on a level playing field.

51. In making its decision to convert, the board of directors believed that becoming a publicly-held company would strengthen retention through the use of equity incentives such as stock options and other stock-based awards. However, the need for equity incentives is not supported by the data. PriceWaterhouseCoopers studied Premera's turnover rates and found that company-wide turnover rates were significantly lower than industry rates, as were turnover rates for executive management. In addition, Premera has generally implemented above market compensation practices in comparison to similarly-sized Blue plans, with senior vice-presidents and the top five executives receiving total compensation significantly above market. (Issues regarding compensation are discussed in more detail in Section H of the Findings.)

52. There are negative financial impacts of conversion. Premera will be at risk to lose certain favorable tax attributes that could raise its book tax rate from 20% to 35% in the near term and its cash tax rate in the longer term. (Tax issues are discussed in more detail in Section G of these Findings.) Its premium tax in Alaska will be raised to 2.7% from 2.0%. Premera has estimated that it will have ongoing public company expenses annually of $3.5 million.

53. Premera believes that conversion would permit it to achieve "strategic flexibility" by obtaining access to additional capital from the equity markets. However, Premera has planned for and can successfully pursue its objectives of improved services and products, growth, and increased operational efficiencies without converting to a for-profit.

54. I am persuaded that the speculative benefits that might flow from Premera's added strategic flexibility, if any, would not outweigh the likelihood of harm to subscribers, to the insurance-buying public, and to the public interest, as further explained in this Final Order.

**C. Review of Economic Impact of Conversion**

55. Among the issues presented by the governing statutes are 1) whether the resulting entity's plans for material change are unfair and unreasonable to its policyholders and not in the public interest, and 2) whether the transaction is likely to be hazardous or prejudicial to the insurance-buying public. Both issues require me to consider potential future impacts of the proposed transaction.

56. Evidence was introduced as to whether a for-profit Premera would lower provider reimbursements, raise premiums by more than the market rate of increase, pull out of less profitable markets, and/or take other problematic actions. Evidence was also introduced as to a for-profit Premera's projected net income, growth, and operating margins.

57. PriceWaterhouseCoopers' *Economic Impact Analysis* ("the PWC Analysis"), which I find credible and accept, studied Premera's current and projected income, expenses, and target operating margins in individual, small group, large group and administrative service contract lines. PWC analyzed Premera's projections through 2007, and made findings and conclusions about Premera's projected and target operating margins for each line of business.[9] Individual lines have historically been the least profitable and in most recent years have been unprofitable.

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[9] The information as to projections for each line of business and PWC's findings and conclusions as to that information is set forth in the substantive portions of pages 65 through 74 of the PWC Analysis, but has been redacted from the public version because the information is confidential. This decision will discuss all such confidential items very generally. Attachment B to this Final Order, which is subject to Attorneys Eyes Only confidentiality protection, discusses the confidential PWC findings and conclusions which support my decision.

58. Small groups, while not subject to all of the same pressures as individuals, have fewer options (such as self-insurance) than large groups and generally do not wield the same bargaining power as large groups.

59. PWC's Analysis[10] concluded that, to meet the margins demanded by the financial markets, premiums must increase, or administrative costs or provider reimbursements must decrease. PWC concluded that such premium increases are constrained by the competition in Western Washington but are not so constrained in certain counties in Eastern Washington where Premera has market power. PWC concluded that, because of Premera's smaller market share in the large group line and large groups' ability to self-insure, the premium increases necessary to meet Premera's target margins could not be successfully imposed on that group. PWC further concluded[11] that Premera has sufficient market power in certain Eastern Washington counties in the small group and individual lines to impose the premium increases necessary to meet such target margins.

60. The PWC Analysis also concluded that, to reach the operating margins demanded by the financial markets, premium increases of 8% to 10% for the individual line of business in 16 counties in Eastern Washington where Premera has market power would be required. PWC further concluded that, to reach the operating margins demanded by the financial markets, premium increases of 2% to 4% for the small group line of business in 18 counties in Eastern Washington where Premera has market power would be required.[12]

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[10] Cantilo & Bennett's October 2003 Final Report, at pages 66 – 73, reached came to the same conclusions.

[11] PWC's conclusion in this regard was in part based on the work done by Dr. Leffler.

[12] PWC's model used those counties where Premera has at least a 65% market share.

61. I believe that to satisfy the investment community Premera, as a public company, would be required to produce continuous and significantly increased growth in such key metrics as net income and operating margins.

62. Premera chooses to downplay these benchmarks used by investors. Instead, it prefers to focus on projected growth in membership and revenues. However, PWC concluded that Premera would face serious challenges to its growth in Washington because this state already has a higher rate of health insurance coverage than the national average, as well as a relatively high unemployment rate and slowing population growth. Although revenue is one factor in looking at a company's financial condition, it is tied to membership growth. An increase in revenue may also simply reflect increased premiums due to inflation in the costs of medical care.

63. Premera's witnesses Gubby Barlow, Chief Executive Officer, and Audrey Halvorsen, Senior Vice President and Chief Actuary, suggested that Premera would be able to increase margins through administrative cost savings. Premera did not specify how such savings could be achieved.

64. Premera did not present evidence of what level of savings, if any, its recent IT improvements have achieved, or what level future investments would be expected to bring.

65. Premera did not present credible evidence of what level of savings, if any, its care management programs would be expected to bring.

66. PWC believes Premera would be forced by the investor markets to allocate to each line of business its full cost. Premera's ASC business currently is not bearing its fully

allocated cost and would require a 28% increase in price in order to do so.[13] However, Premera has also said that the ASC business is highly competitive. It does not seem likely that Premera will be able to raise the price by 28% and still achieve significant growth, which would also affect the net income measure.

67. PWC[14] also concluded that Premera's projected margins were lower than those of comparable companies and that it would be difficult for Premera to be viewed as attractive to the stock market unless it was able to improve its financial performance. PWC also noted that a for-profit Premera would have additional administrative costs for financial reporting and investor relations.[15] PWC concluded that Premera's only remaining options for achieving its target margins or the margins expected by the investor community would be to raise premiums and/or lower provider reimbursements.

68. Premera and the OIC Staff retained economists[16] to analyze whether a for-profit Premera would be able a) to raise premiums more than necessary to cover its costs, and/or b) to lower provider reimbursements. The economists agreed that the ultimate question was whether Premera has market power, that is: Does Premera have the ability to increase prices (or lower provider reimbursements) by at least a small but significant and nontransitory amount? I find more credible and generally accept Dr. Leffler's testimony, founded on his broad experience working on antitrust cases for the Department of Justice ("DOJ") and the Federal Trade Commission and his application of the Department of Justice/Federal Trade Commission Horizontal Merger Guidelines, (DOJ/FTC Guidelines").

[13] Failure of the ASC business to meet its target would negatively affect all other lines of business, particularly in future.

[14] See also Cantilo & Bennett's October 2003 Final Report at 70.

[15] Mr. Klopovitz testified that Premera estimated approximately $3.5 million in costs annually associated with being a public company, and he estimated it might be even higher.

[16] Premera retained Thomas R. McCarthy, Ph.D., the OIC Staff retained Keith Leffler, Ph.D.

69. Both experts considered the relevant economic market. Dr. McCarthy concluded that the relevant market is all health insurance products in Washington, including self-insured products and all public or government lines of business distributed or sold by commercial insurers. Dr. Leffler concluded that only commercial insurance products should be considered,[17] and that large group, small group, and individual products in each metropolitan area should be analyzed separately. Dr. Leffler concluded that, even considering larger geographic areas such as all of Eastern Washington and all of Western Washington, Premera's market share showed its dominance in Eastern Washington.[18] Dr. Leffler found that Premera's market share of the insureds reporting to the OIC for individual, small and large plans for the year 2001, the most recent year for which reliable data was available, exceeded 80% in eight counties in Eastern Washington and averaged nearly 70% over all of Eastern Washington. He also found that, in the 14 Eastern Washington counties where Premera has exclusive use of the Blue Shield/Blue Cross mark, it averages a 90% market share.

70. Dr. Leffler testified that, of the four examples Dr. McCarthy offered of successful market entry by Premera competitors into Premera's Eastern Washington markets, one was an existing carrier's acquisition of another existing carrier, another entered and failed, another had very few enrollees in the small group and individual market in the 14 counties, and the last was not an insurer.[19] Further, Dr. Leffler noted, of the six examples Dr. McCarthy offered of successful expansion, one was the same failure he cited as evidence of

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[17] Although Dr. Leffler did not include any government programs (state and federal employee programs, Medicaid or Medicare), he did include self-insurance as a demand substitute for large groups.

[18] Dr. Leffler also testified that, whether he measured market share in the 14 county area for individual and small group separately or collectively, the result was substantially the same.

[19] TR. At 1767, 1768

successful entry, and the others were carriers which have been offering the same line of business as Premera, so they are not examples of successful carrier expansion into new lines in this area.

71. Dr. Leffler testified that self-insurance may be viable for large employer groups, but is not a realistic alternative for small employers or individual purchasers. Further, insurance regulations for each classification are significantly different. Dr. Leffler concluded that to analyze Premera's market share, the relevant market should be divided into large group, small group and individual commercial insurance products.

72. Once the relevant market is defined, market share can be determined. Further analysis is then necessary to determine whether market power exists. If market share is less than 60%, no further analysis is necessary. In the present case, however, because Premera's market share in the 14 Eastern Washington counties where it has exclusive use of the Blue mark greatly exceeds 60%, analysis of market power with respect to those markets is necessary.

73. Dr. Leffler's analysis, consistent with the DOJ/FTC Guidelines, considered possible supply substitutes as pertinent to the ultimate issue of whether Premera has market power.[20] He concluded that, because Premera's market share of the large group market was smaller than it was in the other categories (small group and individual), and because large groups may self-insure, Premera did not have market power in the large group market, even in the 14 counties.[21]

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[20] Both Dr. Leffler and Dr. McCarthy agreed that market share is the starting point, but does not in itself demonstrate whether an entity has market power.

[21] Dr. Leffler's analysis proves much more helpful than Dr. McCarthy's, by enabling me to consider how real world options affect the ultimate question of market power.

74. Dr. Leffler considered other supply substitution possibilities in the 14 counties and concluded that substantial barriers to entry and expansion exist for other carriers. Dr. Leffler reasoned that to compete effectively with Premera, a carrier must establish an extensive provider network essentially mirroring Premera's, because employees are reluctant to switch providers. Employers are also reluctant to undertake the administrative costs of switching to a new carrier. A carrier switch in the largely rural areas at issue generally requires that both the employer and the carrier have a relationship with a health plan broker servicing that area. As Dr. Leffler noted, buyers are also reluctant to switch coverage when the firm seeking their business is new to the market and may be gone if its effort to enter the market is unsuccessful. Premera's exclusive right to use the Blue Shield and Blue Cross marks in the 14 counties also serves as an impediment to entry/expansion by other carriers.[22] Dr. Leffler concluded that Premera has market power in a 14 county area of Eastern Washington.

75. Dr. Leffler considered whether Premera had exploited its market power with respect to premium rates. He opined that, because state regulation of small group and individual health plan pricing requires revenue neutrality, the price of Premera's Eastern Washington products is tied to the price of those products in the Western Washington market. Therefore, Dr. Leffler concluded, because the Western Washington market is competitive, revenue neutrality in effect means that Premera is prevented from raising the price of its Eastern Washington products beyond medical cost trend. However, Dr. Leffler is not an expert in insurance regulation (TR. at 1784-85) and later testimony by those who have more

[22] As discussed above, Dr. Leffler also considered the examples offered by Dr. McCarthy, and concluded that none represented successful entry or expansion.

expertise in that field shed a different light on Dr. Leffler's conclusion with respect to the effect of state price regulation. See particularly the testimony of Lichiou Lee and Martin Staehlin discussed below.

76. Dr. Leffler also analyzed whether Premera had market power with respect to purchasing provider services. Dr. Leffler found that Premera controls 73% of the commercially-insured patient population in the 14 county area. Using Dr. McCarthy's calculation of the numbers of self-insured in Eastern Washington, Dr. Leffler estimated that, including the self-insured, Premera controls approximately 70% of the commercially-insured and self-insured population in the 14 county area. Dr. Leffler compared provider reimbursements of two competing carriers in the 14 county area for 123 common procedure codes with Premera's provider reimbursements and determined that Premera pays less[23] than those competitors in reimbursements for care to small group enrollees. Dr. Leffler concluded that Premera had buying-side market power in the 14 county area, but that Premera had already exercised that power with respect to provider reimbursements.

77. PWC's analysis concluded, consistent with Dr. Leffler's views, that in those counties in Eastern Washington where Premera had a 65% or greater share of the individual and small group market,[24] it had sufficient market power to raise its premiums at least a small but significant and nontransitory amount. PWC also agreed with Dr. Leffler that Premera did not have a sufficient market share in Western Washington to have market power and that large

[23] The specifics of Premera's reimbursement differences are set forth in S-115, but the information is confidential.

[24] PWC identified 16 counties with the requisite market share in the individual line and 18 counties with the requisite market share in the small group line. Dr. Leffler's analysis omitted 2 of PWC's counties for the individual line and 4 of those in PWC's small group category because his break point was more demanding. He ended up using only the 14 counties where Premera had exclusive use of the Blues brand and a certain market share, which is more full explained in confidential Attachment B.

groups' access to self-insurance in Eastern Washington weakened Premera's market power in that line.

78. PWC created a model to study what would happen in the 14-county area of Eastern Washington if Premera used its market power to raise premiums to meet its target margins. I find credible and accept PWC's conclusion that, if Premera does not lower provider reimbursements[25] or lower its administrative costs beyond its projections, it will have to raise premiums in the 16 county area significantly[26] above market trend in the individual line and in the small group line in the 18 Eastern Washington counties to meet its target operating margin for the individual and small group lines of business.

79. OIC's Chief Actuary, Lichiou Lee, noted, and Audrey Halvorsen, Premera's Chief Actuary generally agreed, under Washington insurance law, the OIC does not have authority to disapprove individual rates, which are filed for informational purposes only.

80. Ms. Halvorsen testified that Premera's increase of rates and margins in the small group market in the 14 county Eastern Washington area to meet target margins would violate Washington insurance law, which requires overall revenue neutrality. Under the principle of revenue neutrality, any increase of profitability in the 14 counties must, according to Ms. Halvorsen, be balanced by a corresponding decrease of profitability elsewhere.

81. Ms. Lee, whose testimony I find credible and accept, agreed that the Washington law requires revenue neutrality, but noted that a slight alteration in the design of

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[25] All parties concluded that the competition in Western Washington prevents Premera's lowering provider reimbursements there. Dr. Leffler concluded that Premera's provider reimbursements are already lower than its peers in Eastern Washington and considerably lower than its Western Washington reimbursements, presumably due to Premera's exercise of its market power in the 14 Eastern Washington counties where Premera has exclusive use of the Blues brand.

[26] The specific necessary percentage is confidential and in Attachment B.

an existing insurance product would create a new product, not subject to the revenue neutrality requirement.

82. Mr. Staehlin, whose testimony I find credible and accept, explained that rate filings are composed of hundreds of elements for each of the factors that permit carriers to adjust rates. Mr. Staehlin agreed with Ms. Lee that one way to sidestep the revenue neutrality requirement is to alter a product's characteristics slightly and treat it as a new product, thereby negating the prior product's claims experience and allowing a carrier to use "actuarial judgment" to fill the gap. Mr. Staehlin's testimony demonstrates that the actual complexity of rate filings and a carrier's ability to make alterations such as ones he and Ms. Lee suggested would enable Premera to achieve its target margins by raising premiums or taking other anti-competitive actions in those areas where it has market power.

83. Premera has proposed economic assurances that are intended to mitigate the affect of the conversion on premiums for the individual and small group markets in Eastern Washington. To the extent the assurances offer any mitigation, it is only for two years, after which time the assurances expire.

84. The assurances are also, as a practical matter, mostly ineffective. Because the rates in the individual market are not approved by the OIC and are essentially unregulated, the assurances will not constrain individual rates. In addition, as testified to by OIC Actuary Lichou Lee and expert actuary Martin Staehlin, there is also a considerable amount of maneuverability that Premera will retain in rating products in the small group market. By simply adjusting benefits in any given small group product, the assurances become ineffective.

85. Premium increases beyond market trend would pose an unacceptable risk that consumers would have to forgo insurance coverage resulting in patients deferring or avoiding

medical care, not following prescribed treatments, and over utilizing emergency rooms. The public witnesses, particularly in Eastern Washington, overwhelmingly raised the concern that, with few to no alternatives to Premera for coverage, premium increases would price them out of insurance and jeopardize their ability to obtain medical care.

86. Report 2 of the UW Health Policy Analysis Program cited results of an annual study by the California Medical Association which found that, of the ten managed care health plans that spent the largest proportion of premium revenue on health care, eight were non-profits. The HPAP study also found that the medical loss ratio of WellPoint, the nation's oldest converted Blues plan, was lower than all of its major competitors. Similarly, Missouri's converted Blues plan, subsequently bought by WellPoint, has decreased its loss ratio since conversion and now has the lowest loss ratio of all its major competitors. The HPAP Report also noted a report by Conover C. and M. Hall, *For-Profit Conversion of Blue Cross and Blue Shield of North Carolina: Assessment of the Potential Impacts on Accessibility and Affordability of Health Care, Report to the North Carolina Department of Insurance* April 2003, which established that loss ratios for investor-owned Blues plans have been about 10 percentage points lower than for nonprofit Blue plans.

87. I believe that the risk in the present case of decreased spending on medical care is unacceptable. To permit conversion in view of this risk would be unfair and unreasonable to Premera's subscribers and not in the public interest, and would be hazardous and prejudicial to the insurance-buying public.

88. I believe that the risk of excessive rate increases, as described by PWC's model, is unacceptable. To permit conversion in view of this risk would be unfair and

unreasonable to Premera's subscribers and not in the public interest, and would be hazardous and prejudicial to the insurance-buying public.

### D. Review of Premera's Obligation to Transfer Fair Market Value to the Foundations

89. Premera asserts that it has no charitable trust obligation and, therefore, is not required to transfer its assets upon dissolution to a nonprofit entity that is engaged in similar beneficial activities. Premera contends that its transfer of assets to the Foundations would constitute a voluntary gift, upon which it may place whatever restrictions it chooses, even if such restrictions dilute or decrease the value of the assets.

90. Premera further asserts that the Foundations are entitled only to the value derived from the stock with the restrictions in place. Premera likens this to gifting a piece of property subject to a mortgage or an easement.

91. Premera's obligation to convey all of its assets upon dissolution existed, however, before it created restrictions on the sale and control of the stock. The fact that Premera has, for its own reasons, elected to convey its assets by transferring the value of the company through stock does not relieve it of the obligation to transfer what would have been the fair market value of those assets had it performed an independent appraisal or entered into an arms-length negotiated sale.

92. Neither Premera nor the OIC Staff undertook the legal and factual analysis to determine if Premera's assets are held as a charitable trust under Washington law. The OIC Staff reasonably assumed, based on Premera's representations to me, the Attorney General, and in the Form A, that Premera's conversion plan was intended to convey fair market value to the Foundations. It was not until after the OIC Staff consultants issued their final reports in October 2003, in which they identified certain restrictions and provisions in the transaction

documents that would affect the value of the stock to the Foundations, that Premera claimed it neither intended nor was obligated to convey fair market value.

93. Regardless of whether a charitable trust exists, Premera is obligated to transfer the fair market value of its assets to the Foundations by the terms of the Form A and by the requirements of its Articles of Incorporation, the Washington Nonprofit Corporation Act, and the Holding Company Act.

94. Premera is a nonprofit corporation organized under the Washington Nonprofit Corporation Act, Chapter 24.03 RCW. Its parent, PREMERA, is a nonprofit corporation formed under Chapter 24.06 RCW. Premera's predecessor was formed in 1945 by the Washington Hospital Service Association under the charitable corporation laws for the purpose of providing hospital care to subscribers and thereby promoting their general and social welfare. In the 1990's the Medical Service Corporation ("MSC") was acquired by PREMERA and later merged into Premera Blue Cross. MSC was a nonprofit entity formed by physicians to "secure to low wage earners and to their families, health services . . . of which many such individuals and their families have heretofore been deprived."

95. Premera is not owned by its directors, officers, or members, and no part of the income of the company is distributable to its directors, officers, or members. RCW 24.03.005(3).

96. As Premera Board Member Sally Jewell testified, the board of directors' decision to structure the reorganization whereby "100 percent of the value – 100 percent of the stock was transferred to the foundation[s]" was a recognition that the "accumulated capital of Premera over time since it was founded in the '40s here [Washington] and in the'50s in

Alaska comes from the retained earnings and the operating margins of many, many, thousands of people in those states, residents in those state over the years."

97. Article VIII of Premera's Articles of Incorporation states that upon dissolution, all of the proceeds of its assets must be distributed to its parent, PREMERA. Article XII of PREMERA's Articles of Incorporation states that upon winding up and dissolution, PREMERA's assets shall be distributed to "one or more nonprofit entities to be used exclusively for purposes consistent with the purposes" of PREMERA.

98. The reorganization plan outlined in the Form A provides for the dissolution of Premera and its nonprofit parent, PREMERA. RCW 24.03.225(4) and 24.06.265(3) requires that a dissolving nonprofit corporation distribute its assets in accordance with its articles of incorporation or bylaws.

99. Premera submitted the Form A to the Attorney General for review pursuant to RCW 24.03.230, thereby acknowledging her authority to review Premera's plan of distribution of assets in accordance with RCW 24.03.225(3). RCW 24.03.225(3) requires that upon dissolution, assets of a nonprofit company "received and held by a corporation subject to limitations permitting their use only for charitable, eleemosynary, benevolent, educational or similar purposes . . .shall be transferred or conveyed to one or more" entities engaged in substantially similar activities to those of the dissolving corporation.

100. In letters to the Insurance Commissioner and the Attorney General, dated May 30, 2002, Premera explained that "[a]fter completion of the reorganization, the [Foundations] would hold 100% of the initial stock of New PREMERA, *representing the entire ownership interest of New PREMERA at the conclusion of the reorganization*." Emphasis added.

101. The Form A describes the transfer to the Foundations variously as "100% of the stock of New PREMERA," or "100% initial ownership of New PREMERA," or "100% of [New PREMERA's] assets."

102. In reviewing the Form A under the Holding Company Act, I must review the terms of the transaction, including the "source, nature, and amount of consideration used or to be used in effecting the acquisition of control, a description of any transaction in which funds were or are to be obtained for any such purpose, including a pledge of assets, a pledge of the health carrier's stock, or the stock of any of its subsidiaries or controlling affiliates, and the identity of persons furnishing the consideration." RCW 48.31C.030(2)(b).

103. Information regarding the consideration to be paid is relevant to determinations under the Holding Company Act of whether (1) the newly acquired domestic carrier is able to satisfy the financial requirements for being a health carrier after the acquisition; (2) the financial condition of the acquiring party might jeopardize the financial stability of the health carrier or prejudice the interest of its subscribers; (3) plans of the acquiring party to liquidate the health carrier, sell assets, or make other material changes are unfair and unreasonable to subscribers of the health carrier and not in the public interest; and (4) the acquisition is likely to be hazardous to the insurance-buying public. RCW 48.31C.030(5)(a).

104. Reviews of transactions under the Holding Company Act typically examine the consideration paid to assure that the domestic company and, in turn, its subscribers are not being harmed or prejudiced by receiving less than fair value. In addition, the nature and source of the financing is important to ensure that neither party to the transaction is being compromised financially by engaging in the transaction.

105. Because Premera is not seeking to convert by being acquired by another insurer, there is no arms-length negotiated purchase price to establish value. Premera did not propose conveying the dollar value of its assets based on an independent appraisal - including but not limited to its investments, goodwill, contract rights, intellectual property rights, hardware, and software. Premera would understandably not convey its actual assets to the Foundations because that would put the company out of operation. Rather, Premera has elected to undergo a stand alone conversion by issuing stock and conveying that stock to the Foundations, which would realize the value of Premera's assets by monetizing the stock over time.

106. When an acquisition is between a buyer and a seller negotiating at arms length, the assumption is that the amount of the consideration and the structure of the financing will be fair. Indeed, each party generally obtains a fairness opinion from its bankers or consultants to that effect before consummating the transaction.

107. An acquisition as a result of a stand alone conversion from nonprofit to for-profit presents different issues relating to consideration under the Holding Company Act. First, there are not two parties negotiating at arms length over a purchase price. Instead, the terms of the transaction are controlled, except for my review, by the company converting. Second, the value to be received is not a specific dollar amount derived from a sale, but is derived from the issuance of stock that will be monetized over time.

108. The only way to judge the fairness of the value produced under these circumstances is to review process and terms for issuing, controlling, and monetizing the stock. Assuming that the process and terms are fair and reasonable, one can reasonably assume that the dollar amount that ultimately will be derived represents the fair market value. Further,

because Premera is not owned by its management or shareholders, I must also take into account the public interest in receiving the beneficial value of the company.

109. The Legislature did not limit my review under the Holding Company Act of issues relating to the source, nature, and amount of the consideration simply because the acquisition of control takes place via a stand alone conversion rather than a third-party sale. Indeed, the fact that the present transaction is not the result of arms-length negotiation makes regulatory review even more important.[27]

110. I must also consider Premera's obligations to comply with its own Articles of Incorporation and the Washington Nonprofit Corporation Act. Otherwise Premera could undertake a transaction in violation of the law that later could be challenged or overturned, resulting in damage to the company and harm to its subscribers.

111. The OIC Staff consultants opined that, even though Premera did not perform a valuation and commit to transfer a fixed fair market value dollar amount to the Foundations, a properly run IPO and properly structured transaction could still result in the transfer of fair market value.

112. As is discussed in more detail below, Premera's plan to raise \$100 to \$150 million will significantly dilute the value of the sock to be received by the Foundations. Additionally, Premera has placed an array of restrictions and conditions on the Foundations'

[27] In reality, Premera's entire reorganization and conversion plan is an intercompany transaction. All of the assets, represented by shares of stock, are being transferred from the nonprofit Premera holding company system and being acquired by the for-profit Premera holding company system. The same board and management are controlling the terms of the transfer and the acquisition. Intercompany transactions are governed by a standard of whether the terms are fair and reasonable. RCW 48.31B.030 and 48.31C.050. This standard is necessary to prevent conflicts of interest and financial self-dealing. Premera asserts that this standard does not apply to a Form A. I believe it is a reasonable interpretation of my authority to review a Form A to consider whether the terms of the acquisition are fair and reasonable as part of my decision on whether the transaction is unfair and unreasonable to subscribers, not in the public interest, or hazardous or prejudicial to the insurance-buying public. RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II); RCW 48.31B.015(4)(a)(vi); RCW 48.31C.030(5)(a)(ii)(C)(IV).

ability to exercise control of the stock and divest the stock. Because of these problems, the OIC Staff's investment banker consultants are unable to opine that the transaction as a whole is fair to the public from a financial point of view.

**E. Review of Dilution of the Value of the Stock to the Foundations**

113. There are three types of dilution to the value of stock. The first is ownership dilution, which means in this context that, although at the time of the conversion the Foundations will own 100% of the newly issued stock, their ownership interest will be reduced when New PREMERA sells additional stock in the IPO. This may not result in a reduction in value to the Foundations, as Mr. Koplovitz from the Blackstone Group testified, if in fact the "pie is bigger." However, in order for the pie to be bigger, the additional issuance of stock by Premera must result in increased earnings and an increase in value of the company.

114. Earnings dilution looks at expected earnings to determine if, taking into account the expense of raising equity capital, that capital will be used in a manner that will increase earnings. The Blackstone Group has calculated that Premera's plan to raise $150 million and place the money in bonds is 15% dilutive to the earnings of the company. The result of this dilution is that the price that the Foundations will be able to receive for their stock, which is based in part on the earnings of the company, will be reduced. Blackstone opined that the amount of dilution is excessive and not fair to the Foundations and the public. I accept that opinion.

115. The last type of dilution is value dilution, which looks at the long term use of the capital. Equity capital is expensive to raise. If the capital is not used in a manner that increases value over the long term, there will be dilution of value resulting in lower stock prices and, therefore, reduced proceeds for the Foundation.

116. In conversions of this kind in other states, the converting plans did not raise the amount of capital that Premera is planning to raise. In addition, it has been the experience of the OIC Staff's consultants that companies intending to convert to for-profit to raise capital have prepared much more definitive plans for the use of that capital, so there can be an analysis as to whether the planned capital projects will increase the earnings and value of the company.

117. In the amended Registration Rights Agreement and Plan for Conversion in the Form A, Premera agreed to consult with IPO Advisors acting on behalf of the Foundations regarding the pricing, amount, and allocation (as between New PREMERA and the Foundations) of the securities to be offered at the IPO. The Washington Foundation's IPO Advisor, presumably the Blackstone Group, could also issue an IPO procedures opinion just prior to the IPO to opine on whether the IPO was marketed and conducted fairly and in the customary manner. However, my decision on the Form A is based on the representations by Premera that it intends to raise \$100 to \$150 million from the IPO and that currently there are no specific plans for that capital other than purchasing bonds. This will result in significant dilution in value of the shares to the Foundations.

118. The opportunity for the IPO Advisor to consult and issue a procedures opinion on the eve of the IPO is not a substitute for presenting to me a conversion plan prior to a decision on the Form A that shows Premera's intention and ability to transfer fair market value to the Foundations. Premera has not done that; therefore its plan for conversion is not fair and reasonable to the public and not in the public interest.

### F. Review of Restrictions on Control and Sale of Stock

119. Each Blue plan is required to sign a license agreement with the Blue Cross and Blue Shield Association. The agreement contains a provision that, if the plan becomes for-

profit, it will lose its license if any individual owns five or more percent of the stock or any institutional investor owns ten or more percent of the stock. These limitations do not apply to the ownership interest of another Blue plan.

120. The BCBSA has made accommodations regarding this license provision where stock was issued to a foundation or similar entity as part of a conversion plan.

121. The license also requires that the members of the board of directors pre-conversion must remain in control post-conversion.

122. Other than these two restrictions in the license agreement, no other conditions on converting to for-profit are issued by the BCBSA in a written agreement or written guidelines.

123. Premera has not received an explanation from the BCBSA of the reasons for the conditions purportedly required by the BCBSA in this transaction.

124. The BCBSA is managed by the CEOs of all the Blue plans.

125. Premera asserts that if it undertakes a transaction without the conditions that the BCBSA has purportedly placed on Premera, Premera will lose its license.

126. The Blue license is a valuable asset. Premera would not convert, if conversion resulted in the loss of the license.

127. I am not bound by conditions that BCBSA may place on its plans to allow them to convert and still retain a license. I may find that any one condition or combination of conditions constitutes reason for disapproval of the Form A.

128. Premera has placed restrictions on the Foundations' ability to control and trade the stock and to have its interests represented.

129. The Voting Trust and Divestiture Agreement ("VTDA") treats the Foundations as single entity for purposes of the mandatory divestiture schedule and the ability to vote their shares of stock. The Foundations are required to sell their shares of stock so that together they own less than 80% of the issued and outstanding shares of stock prior to year one, 50% prior to year three, 20% prior to year five, and 5% prior to year ten. In addition, the Foundations are permitted (with some exceptions discussed below) only to vote one share less than 5% in the aggregate of the outstanding shares of common stock.

130. The Foundations are separate entities, with separate boards that are appointed by each state's respective public officials. The Foundations will have separate missions and serve different constituencies. They are likely to have different interests and different plans in how they desire to monetize the stock. But for the restrictions placed on the Foundations by the VTDA, they would be separate individual investors entitled to exercise up to, but less than, 5% ownership rights under the BCBSA license agreement.

131. While public investors may view a predictable plan for divestiture favorably, the mandatory divestiture schedule deprives the Washington Foundation of significant control over its shares, which may force the Foundation to sell its shares during a downturn in the market. An aggregated divestiture schedule exacerbates the problem of lack of control, because it may force the Washington Foundation to sell shares that it would not be required to under an individual schedule.

132. The Foundations are further stripped of control over their stock by being required to vote their shares in the aggregate. The Foundations, which will initially own 100% of New PREMERA, will be required to contribute 95% plus one share to the voting trust and to make further contributions from time to time so that so that the number of shares controlled

outside the voting trust by the Foundations in the aggregate never exceed one share less than 5% of the outstanding stock. If the Foundations can not agree on how to divide the voting power, the Washington Foundation may vote all of the voting shares.

133. Investors may look favorably at a significant contribution by the Foundations of voting power to the trust. However, requiring the Foundations to vote the small percentage allotted to them in the aggregate further deprives them of control over their shares, treats them less favorably than other individual investors would be treated under the BCBSA license agreement, and places the Foundations in conflict with each other.

134. Premera suggests that conflicts between the two states' Foundations regarding divestiture and voting power should be resolved by the Foundations when they arise. However, I am persuaded that it is not in the public interest to structure the transaction so that the Foundations will be placed in inherent conflict with each other. In addition, as recommended by the OIC Staff consultants, the divestiture deadlines should apply individually to each Foundation so that the Washington Foundation can meet ownership deadlines on the shares it owns and controls. Also as recommended, the Washington Foundation should be free to vote in its own right one share less than 5% of the outstanding shares of stock. I am persuaded that the Foundations will have ceded significant control by complying with a divestiture schedule and voting trust, and that forfeiting more control through aggregated divestiture obligations and voting rights is not fair and reasonable and further reduces the value of the stock to the Foundations.

135. The VTDA also requires that the Foundations own no more than 80% of the outstanding shares of stock one year after the IPO. The Blackstone Group recommends that

this provision be eliminated. Premera asserts that this is a BCBSA requirement, although it was not included in the WellCHOICE conversion.

136. There are perceived benefits by investors of predictable divestiture. However, this first year requirement places the Foundations at risk of potentially having to sell additional shares in a relatively short time after the IPO when the market may not be advantageous. The fact that the divestiture obligation is aggregated with the Alaska Health Foundation exacerbates the potential risk to the Washington Foundation. I am persuaded that the combination of these two factors reduces the value of the stock. In addition, the perceived benefit by public investors of a forced divestiture of this amount the first year is questionable in light of the fact that such a provision was not required in the WellCHOICE conversion.

137. There are numerous other provisions, as described below, that further restrict the Foundations' ability to exercise control over their stock, to be represented consistent with their ownership interests, and to participate freely in the governance of New PREMERA on material issues. I am persuaded that these restrictions unreasonably interfere with the Foundations' interests and thereby reduce the value of the stock to the Foundations.

138. The VTDA permits the Foundations to freely vote their shares, i.e. the trustee must vote the shares in trust as the Foundations direct, on a change of control proposal resulting in New PREMERA shareholders owning less than 50.1% of the company post-transaction. The Blackstone Group recommends that the Foundations be given the right to freely vote their shares if a change in control proposal results in the New PREMERA shareholders owning less than 80% of the company, because such transactions would have a material impact on the value of the Washington Foundation's ownership interest in New PREMERA. This recommendation is consistent with the New York Stock Exchange rules

which indicate that, if a company issues more than 20% of its shares as new shares, it must obtain the approval of its stockholders.

139. The Washington Foundation is permitted to nominate a member of the board, who must meet stringent qualifications, including experience on a board or as an officer of a public company or partner/managing director of a national firm, as specified in the VTDA. The member is selected by Premera's board of directors from a slate of three candidates chosen by the Washington Foundation. However, the board retains the right to veto all three candidates and force the Foundation to offer different candidates, even if the candidates meet the qualifications.

140. Premera asserts that it needs the veto in order to ensure that the Foundation member is not only qualified but also has the "right chemistry" to work with the other members of the board. In essence, Premera can nullify the Foundation's right to board representation of its choosing by rejecting qualified candidates simply because Premera does not perceive there is the "right chemistry." The stringent qualifications for nomination to the board are sufficient protection for Premera without imposing additional subjective conditions on the Foundations' right to representation.

141. Premera also has placed a limitation on Foundation board representation of five years or less than 5% ownership interest, whichever occurs first. Given the divestiture schedule, blackout periods when no shares can be sold, and other delays, the Washington Foundation could still have a material equity interest in Premera of as much as 50% of the company after five years and 20% of the company after seven years.

142. The Blackstone Group has recommended that there be a threshold of a number of shares after the five-year period below which the Foundations' ownership would have to

drop before board representation is terminated. Given the fact that there is a divestiture schedule that will compel the Foundations to reduce their interest in the company, I am persuaded that board representation should be determined by ownership interest rather than an arbitrary time limit.

143. Although Premera asserts that many of the provisions in the VTDA that are objectionable to the OIC Staff and their consultants are included because of BCBSA requirements, Premera insists that the VTDA should stay in force even if the Blue license were lost post-conversion. The consequence is that the Foundations, which may be holding a substantial interest in the company at the time the license is lost, would not be able to freely control and vote their shares as any other stockholder could in order to influence the future course of the company. Indeed, control may remain with minority interests in the company and a board and management that were at the helm when the events occurred that resulted in the loss of the license.

144. During the hearing Premera questioned whether the Foundations' boards would be up to running an insurance company if they could freely vote their shares. This is not a reasonable concern. A majority shareholders of a troubled company do not necessarily run the company; rather, they have the voting power to select individuals from within and without the company to turn the company around. The need for the VTDA to remain intact is also suspect by the fact that there was no such requirement in the WellCHOICE conversion. I am persuaded that the perpetuation of the VTDA after the loss of the Blue license serves the interests of the board and the management but not the interests of the company's subscribers and the Foundation and public shareholders.

145. Because of the voting trust, the Foundations' shares would be voted by the independent directors of the board of New PREMERA, except where the Foundations are specifically granted the right to vote some or all of their shares outside the trust. The Foundations would not be able to control how their shares are voted. It is important, therefore, that these directors be truly independent so that the value of the Foundations' interest in New PREMERA would not be prejudiced.

146. The definition of "independence" is found in Article II, Section 4(f) of the New PREMERA by-laws and provides that a director will be considered independent if the director is not employed by or has an immediate family member that is an executive officer of another company that accounts for at least 2% or $1 million, whichever is greater, of New PREMERA's consolidated gross revenues, or for which New PREMERA accounts for at least 2% or $1 million, whichever is greater, of such other company's consolidated revenues.[28] The result is that an employee of a major customer of New PREMERA, perhaps representing as much as $56 million dollars in revenue, could be considered "independent."

147. Martin Alderson-Smith of the Blackstone Group testified that the proposed 2% rule is currently the minimum qualification followed by the New York Stock Exchange. However, in light of recent financial scandals, where the independence of boards has been questioned, many companies are adopting more stringent qualifications. Mr. Alderson-Smith identified the independence of the board as an important issue and recommended that

[28] In its closing brief, Premera suggested amendments to New PREMERA's by-laws and the VTDA to address the issues of independence of directors, veto of Foundation candidates to the board, divestiture allocation, and perpetuation of the VTDA if the Blue license is lost. The amendments do not withdraw the unacceptable provisions but appear to seek a compromise through revisions of the language. The taking of evidence concluded on the last day of the formal hearing. The OIC Staff, the Interveners, and their consultants are deprived of the opportunity to review and provide testimony on amendments that are submitted after the evidentiary record has been closed. Therefore, I am relying on the language in the documents and the testimony given as of the last day of the hearing in my decision on these issues.

qualifications for independence be revised to provide that the standard be the lesser of 2% or $1 million. I am persuaded that it is in the interest of protecting the Foundations' ownership value and in the interest of the public shareholders that the qualifications for independent directors should be more restrictive than what is currently adopted in the proposed by-laws.

148. Premera has one year to complete the IPO but has reserved to its own discretion two automatic three-month extensions. While the one year is standard for this type of transaction, the automatic extensions are not, as testified to by Mr. Koplovitz of the Blackstone Group. The longer it takes to complete the IPO the greater likelihood that there will be a material change in circumstances that could affect the value of the Foundations' interests. If an extension were warranted, it should be taken either with the agreement of the Foundations and Premera or with my approval.

149. As testified to by the OIC Staff's investment banking experts from the Blackstone Group, Mr. Koplovitz and Mr. Alderson-Smith, Premera's plan for conversion will not transfer to the Foundations the fair market value of Premera's assets.

150. Because of the various deficiencies in Premera's plan for conversion, the Blackstone Group is unable to opine that the plan, taken as a whole, is fair to the public from a financial point of view.

151. I am persuaded that the weight of the evidence supports the finding that Premera's plan for conversion does not convey fair market value, is not fair and reasonable to the public, and is not in the public interest.

152. The failure of Premera to transfer fair market value would undermine any possible mitigation that the creation of a Washington Foundation could have on the hazardous

and prejudicial effects of the conversion on subscribers, the insurance-buying public, and the public in general.

### G. Review of Tax Issues

153. PWC's Report on Tax Matters, which I find credible and accept, states that Premera has obtained a draft short form tax opinion from Ernst & Young as to whether the proposed transaction constitutes a "material change" for purposes of application of Section 833 of the Internal Revenue Code. That draft short form tax opinion has not been admitted in this proceeding.

154. Mr. Ashley, the person at PWC who prepared the Tax Reports, whose testimony I find credible and accept, testified that the Internal Revenue Service informally opined that the proposed transaction would constitute a "material change" sufficient to cause Premera to lose the Section 833(b) special deduction. Mr. Ashley also testified that loss of the special deduction would result in a 15% increase of Premera's tax rate and corollary loss to Premera's bottom line of 15%. PWC's Report Addendum advised, unless a final tax opinion was submitted, to assume that the transaction would constitute a "material change."

155. I believe that the risk of loss of the special deduction by Premera as a result of the transaction is, in light of the other risks of the transaction, unacceptable. To permit conversion in view of these risks would be unfair and unreasonable to Premera's subscribers and not in the public interest and would be hazardous and prejudicial to the insurance-buying public.

156. Premera submitted evidence, which I find credible and accept, that the transaction will qualify for tax-free treatment pursuant to Sections 351 and 368 of the Internal Revenue Code, that the distribution involved in the transaction will qualify as a tax-free

distribution pursuant to Section 355 of the Internal Revenue Code, and that the transaction should not cause Premera or New Premera to under an "ownership change" as defined in Section 382(g) of the Internal Revenue Code.

### H. Review of Compensation Issues

157. The evidence submitted in this proceeding included analysis of Premera's current executive compensation practices and its plans for post-conversion compensation practices. Premera retained Towers Perrin and OIC Staff retained PriceWaterhouseCoopers ("PWC") to provide expert testimony with respect to Premera's executive compensation programs. This evidence is relevant to my consideration of whether the proposed transaction will result in executive compensation which is unfair and unreasonable to Premera's subscribers and not in the public interest or hazardous or prejudicial to the insurance-buying public.

158. PWC, whose *Executive Compensation Review* and related Addendums I find credible and accept, found that some elements of Premera's current executive compensation programs are more generous to its executives than those of comparable companies, particularly other Blue Cross/Blue Shield companies. Towers Perrin, whose evidence of Premera's executive compensation philosophy I find credible and accept, reported that Premera's executive compensation philosophy is to target base compensation at the median of Premera's peer group. Premera's executive compensation programs will continue after the conversion, as will Premera's current method of developing and implementing such programs (aside from addition of a Foundation-nominated board and committee member). After the transaction, Premera's peer group will clearly be the for-profit health insurance industry and, if the current, more generous elements of the compensation programs continue while the base

compensation target moves upward, the result may well be an overly generous executive compensation package. Therefore, I conclude that this evidence is relevant to my concerns under the governing statutes.

159. PWC analyzed Premera's rate of turnover over the period 1999-2001 utilizing only voluntary terminations and found that in aggregate it has been significantly lower than industry rates. Towers Perrin analyzed this issue utilizing both voluntary and involuntary terminations and found a higher rate of turnover. I found PWC's analysis more credible.

160. PWC found that Premera's current total direct compensation (salary, annual bonus and long-term incentives) paid to the five most highly compensated executives ("Top Five Officers") and to its Senior Vice Presidents ("SVPs") is at or above the 75$^{th}$ percentile. PWC also found that addition of the supplemental executive retirement benefits ("SERP") to total direct compensation results in total compensation significantly above the third quartile of market practice. While PWC acknowledged that such above-market practice might be justified by a company's performance, PWC also found that Premera's relative performance score was between the 38$^{th}$ and 65$^{th}$ percentile with respect to net written premium growth, operating income, and operating margin. PWC concluded that the compensation for Premera's Top Five Officers is higher than the relative performance of the company warranted.

161. PWC made direct comparisons of Premera's executive pay practices with the practices of three groups of companies – Blue Cross/Blue Shield, health insurance, and for profit public companies. Towers Perrin used a blend of Blue Cross/Blue Shield and other public companies and then compared the blend to Premera's pay practices. PWC performed its own analysis of the executive compensation plans while Towers Perrin relied in part on

work already performed by Watson Wyatt and Mercer Consulting. I found PWC's analysis more credible.

162. PWC found that Premera's Long Term Incentive Plan ("LTIP") for its Top Five Officers and SVPs is based on the participant's base salary at the end of the plan cycle rather than at the time of the award. PWC concluded that Premera's LTIP for its Top Five Officers and SVPs is above market in that respect.

163. PWC found that minimum payments under Premera's LTIP and Annual Incentive Plans are triggered by performance goals which are approximately 50% of target and are understated in comparison to historical, actual performance. PWC also found that those plans have no requirement post-conversion of minimum shareholder return before payment is triggered and that 40% of the annual LTIP award is made on the basis of non-financial performance criteria. PWC concluded that these plans are above market in those respects.

164. PWC found that Premera's DB ("Defined Benefit") Supplemental Executive Retirement Plan ("SERP") is calculated on the basis of the executive's Final Compensation, which includes severance benefits. This plan also credits participants over 45 at hire with up to eight years of credit and no offset for other retirement benefits. PWC concluded that Premera's DB SERP is above market in those respects.

165. PWC found that there are no corresponding offsets for Premera's contributions to the supplemental retirement benefits provided to the Top Five Officers and the SVPs within qualified and non-qualified plans. PWC concluded that those benefits are above market in that respect.

166. PWC found that Premera's Change in Control ("CIC") Policy provides "walk-away rights"[29] to all Top Five Officers and SVPs rather than to just the Chief Executive Officer. PWC found that Premera's CIC Policy protects a prorated portion of an executive's annual and LTI payment in the event of a CIC. PWC concluded that the CIC Policy was above market in those respects among for-profit stock companies.

167. PWC found that Premera's CIC benefits are unusual in that they are provided via company policy rather than through individual agreements with particular executives.

168. PWC found that Premera's 40% match on executives' mandatory compensation deferrals is high compared to market practices.

169. PWC found that Premera's plan to continue its LTIP after conversion, along with the equity (stock) incentive plan, is atypical.

170. PWC found that the base salaries of Premera's executives had increased at a rate that was higher than the market, although their current level was comparable to the market. PWC found that, because the rest of the executive compensation plans are calculated on the base salary, if the past rate of increase continued, executive compensation would come to greatly exceed the market.

171. Towers Perrin's analyses focused on Premera's compensation philosophy and emphasized reliance on the compensation committee as a mechanism for ensuring appropriate executive compensation. Towers Perrin found Premera's philosophy reasonable and the compensation committee mechanism appropriate. I did not find such vague assurances helpful in light of the past practices of awarding above market compensation.

[29] "Walk away rights" are the right to terminate employment for any reason during the 30 days following the one year anniversary of a change in control event and collect 50% of the original Change in Control benefit.

172. Premera offered some compensation assurances in its amended Form A by establishing a peer group of companies as a guide for setting compensation and by allowing a Foundation board member to participate on the compensation committee. However, to the extent the assurances could moderate compensation, they only last for two years.

**I. Review of Allocation Issues**

173. Because the Form A is disapproved, it is not necessary to make any findings regarding the proper allocation of New PREMERA shares between the Alaska and the Washington Foundations.

**J. Conditions**

174. The Holding Company Act permits me to "condition approval of an acquisition on the removal of the basis of disapproval within a specified period of time." RCW 48.31C.030(5)(c). The imposition of conditions in this case cannot adequately remedy the bases of disapproval.

175. The likely affect on premiums in the individual and small group markets in Eastern Washington is an inherent by-product of Premera's ability and eventual need to exercise market power as a for-profit insurer in order to meet investors' expectations. The likely negative impact on Eastern Washington subscribers and the insurance-buying public cannot be rectified by a condition.

176. A decrease in medical expenditures is the likely consequence of Premera having to reduce costs in order to meet investors' expectations. The likely negative impact on subscribers and the insurance-buying public cannot be rectified by a condition.

177. Throughout the review of the Form A, the OIC Staff and their consultants tried to elicit from Premera specific plans for the use of the capital to be raised. Premera would only

articulate the general goal of achieving "strategic flexibility" by increasing RBC and having access to capital for improvements in service and products. Premera has failed to offer any meaningful information about its need to raise $100 to $150 million at the IPO and how the capital will be used. The OIC Staff consultants have opined that Premera's plan to raise substantial equity capital, at considerable expense, and decide later how it will be used is significantly dilutive to the value to be realized by the Foundations and therefore is not fair to the public. This deficiency in Premera's plan for conversion is so fundamental and has deprived me of a full review of the impact of the transaction that it cannot be rectified by a condition.

178. Premera has placed numerous restrictions on the Foundations' ability to control and trade their shares of stock, many of which Premera has stated are required by the BCBSA in order for Premera to maintain its license. As I have explained in this Final Order, some of these restrictions are unfair and unreasonable and result in the Foundations not receiving the fair market value of Premera's assets. I am not bound by the purported restrictions of the BCBSA. I must look at the transaction as a whole and disapprove it if it does not meet the standards of the Holding Company Act, which I have done. Because loss of the Blue license would not be in the interest of the subscribers, the insurance-buying public, or the general public, imposing conditions that will simply substitute one set of problems for another is pointless.

## IV. CONCLUSIONS OF LAW

1. The scope of my authority as Washington State Insurance Commissioner to protect the public interest in matters related to insurance in this state is broad. *See, e.g., National Federation of Retired Persons v. Insurance Commissioner*, 120 Wn.2d 101, 109, 838

P.2d 680, 684 (1992); *Federated Am .Ins. Co. v. Marquardt*, 108 Wn.2d.651, 654, 741 P.2d 18, 20 (1987).

2. Where a nonprofit insurer proposes to convert to a for-profit company, as does Premera in the first such proposal in this state, I interpret Chapters 48.31B and 48.31C RCW as having been adopted by the Legislature to protect the interests of Premera's subscribers, the insurance-buying public, and the general public.

3. My obligation as Insurance Commissioner in reviewing a transaction under the Holding Company Act is to prevent harm to subscribers, the insurance-buying public, and the general public. I would be remiss in that obligation if I waited until the harm occurred and then tried to repair it, at a time that may be too late to fully protect their interests. *See Blue Cross & Blue Shield of Kansas, Inc. v. Praeger*, 276 Kan. 232, 260, 75 P.3d 226, 245 (2003).

4. The antitrust inquiry in RCW 48.31C.030(5)(a)(ii)(B) ("subsection B") is independent of other bases of disapproval set forth in RCW 48.31C.030(5)(a)(ii)(C) ("subsection C"). *See also* RCW 48.31B.015(4)(a)(ii)(B) and (C). The most reasonable interpretation of subsections B and C is that they have the same free-standing weight and that the bases of disapproval in subsection C are not dependent on the antitrust inquiry in subsection B. The contrary interpretation offered by Premera makes no sense. For example, a commissioner would be compelled to approve a Form A if there were no antitrust violation, even if the financial condition of the company was in jeopardy or the management was incompetent or inexperienced. The Legislature could not have intended and the law should not be interpreted to lead to such absurd results.

5. The terms of the Form A and representations made to me and the Attorney General, Premera's and its parent's articles of incorporation, the Washington nonprofit

corporation law (RCW 24.03.225, RCW 24.03.230, RCW 24.06.265), and the Holding Company Act (RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II); RCW 48.31B.030; RCW 48.31C.050) each independently and in combination require that the fair market value of New PREMERA be transferred to the Washington and Alaska Foundations.

6. After weighing all of the evidence, I have affirmatively found the following listed bases for disapproving Premera's Form A. Each conclusion reached is an independent basis for disapproving Premera's Form A.

7. Because premiums in the individual and small group markets will likely increase in the Eastern Washington counties in which Premera has market power as a consequence of Premera converting to a for-profit company, Premera's plan for conversion is unfair and unreasonable to subscribers and not in the public interest. RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II).

8. Because premiums in the individual and small group markets will likely increase in the Eastern Washington counties in which Premera has market power as a consequence of Premera converting to a for-profit company, Premera's plan for conversion is likely to be hazardous or prejudicial to the insurance-buying public. RCW 48.31B.015(4)(a)(vi); RCW 48.31C.030(5)(a)(ii)(C)(IV).

9. Because Premera's medical loss ratio will likely decrease as a consequence of Premera converting to a for-profit company, Premera's plan for conversion is unfair and unreasonable to subscribers and not in the public interest. RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II).

10. Because Premera's medical loss ratio will likely decrease as a consequence of Premera converting to a for-profit company, Premera's plan for conversion is likely to be

hazardous or prejudicial to the insurance-buying public. RCW 48.31B.015(4)(a)(vi); RCW 48.31C.030(5)(a)(ii)(C)(IV).

11. The likelihood of increase in premiums and decrease in medical loss ratio, as a consequence of Premera converting to a for-profit company, is exacerbated by the likely loss of the Section 833(b) special tax deduction, increase in Alaska premium tax, increased annual expenses of operating as a public company, and tendency for above market compensation packages; and, therefore, Premera's plan for conversion is unfair and unreasonable to subscribers and not in the public interest. RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II).

12. The likelihood of increase in premiums and decrease in medical loss ratio, as a consequence of Premera converting to a for-profit company, is exacerbated by the likely loss of the Section 833(b) special tax deduction, increase in Alaska premium tax, increased annual expenses of operating as a public company, and tendency for above market compensation packages; and, therefore, Premera's plan for conversion is likely to be hazardous or prejudicial to the insurance-buying public. RCW 48.31B.015(4)(a)(vi); RCW 48.31C.030(5)(a)(ii)(C)(IV).

13. Because Premera is not transferring the fair market value of the assets of New PREMERA, its plan for conversion does not comply with either the terms of the Form A and representations made to me and the Attorney General, Premera's and its parent's articles of incorporation, the Washington nonprofit corporation law (RCW 24.03.225, RCW 24.03.230, RCW 24.06.265), or the Holding Company Act (RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II); RCW 48.31B.030; RCW 48.31C.050).

14. Because Premera's plan for conversion does not transfer the fair market value of the assets of New PREMERA, it is not fair and reasonable to the public and not in the public

interest. RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II); RCW 48.31B.030; RCW 48.31C.050.

15. Because Premera's plan for conversion significantly dilutes the value of the Foundations' shares in New PREMERA, it is not fair and reasonable to the public and not in the public interest. RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II); RCW 48.31B.030; RCW 48.31C.050.

16. Because of the restrictions, both individually and in combination, placed on the Washington Foundation's ability to control and trade the stock in New PREMERA and to represent its interests on significant matters (as more fully described in Section F of the Findings of Fact), Premera's plan for conversion is not fair and reasonable to the public and not in the public interest. RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II); RCW 48.31B.030; RCW 48.31C.050.

17. Considering Premera's plan as a whole, it is unfair and unreasonable to subscribers, not in the public interest, and likely to be hazardous or prejudicial to the insurance-buying public. RCW 48.31B.015(4)(a)(iv); RCW 48.31C.030(5)(a)(ii)(C)(II); RCW 48.31B.015(4)(a)(vi); RCW 48.31C.030(5)(a)(ii)(C)(IV); RCW 48.31B.030; RCW 48.31C.050.

## FINAL ORDER

**IT IS THEREFORE ORDERED**, this 15th day of July, 2004, that,

Premera's Form A request to reorganize, including converting from nonprofit to for-profit status, is hereby **DENIED**.

Mike Kreidler

MIKE KREIDLER
INSURANCE COMMISSIONER